HELP ?

Smashing the iron rice bowl

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Abstract:
China's financial sector blurs the same lines as its floundering neighbors, but 2 decades of economic reform, rapid growth, accumulating hard currency reserves, and sound macroeconomic performance have led the Chinese leadership to believe they can avoid disaster through more reform. They aim to achieve a socialist market economy, and its success rests on the reform of state enterprises. But Beijing's half-measures and Band-aid solutions reveal its inability to resolve the contradictions that arise when socialism is merged with capitalism. Rice has been China's staple food for thousands of years, and the most important symbol of the party's economic policies has been an unbreakable iron rice bowl, which stood for the cradle-to-grave security offered all citizens. When Deng Xiaoping began in 1978 to transform China from a centrally planned economy to a more free-market economy, his supporters insisted that the iron rice bowl had to be smashed if China was to modernize.

Full Text:

15 MILLION UNEMPLOYED? THE ASIAN financial crisis has captured headlines and the attention of millions of investors. In Indonesia, Thailand, and South Korea, the crisis' source lies in the cozy relationship between government offices, banks, and private evterprises. China's financial sector blurs the same lines as its floundering neighbors, but two decades of economic reform, rapid growth, accumulating hard currency reserves, and sound macroeconomic perormance have led the Chinese leadership to believe they can avoid disaster through more reform, The aim to achieve a "socialist market economy," and its success rests on the reform of state enterprises. But Beijing's half-measures and Band-Aid solutions reveal its inability to resolve the contradictions that arise when socialism is merged with capitalism.

Symbols and slogans, alwaus inportant in Chinese society, continue to provide a litany of the communist party's ideological objectives and accomplishments. Rice has been China's staple food for thousands of years, and the most important symbol of the party's economic policies has been an unbreakabli iron rice bowl, which Deng Xiaoping began in1978 to transform China from a centrally planned economy to a more free-market economy, his supporters insisted that the iron rice bowl had to be smashed if China was to modernize.

China's dilemma is that it is afraid to smash the iron rice bowl because it fears that the social stability that has sustained its reform program would shatter with it. Nevertheless, state-owned enterprises are foundering as subsidies are withdrawn. The government is desperately looking for buyers but they are hard to find. The budget subsidies that once sustained state enterprises and kept the iron rice bowl intact dried up as the capital needs of modernizing enterprises soared while their fiscal contributions plummeted. The government still offers some subsidies, but it will soon have no choice but to close down most state enterprises. As many as 15 million workers will be unemployed and many thousands are likely to take to the streets in protest. For Beijing, time is running out.

A SECOND TIANANMEN?

THE END of the iron rice bowl appeared implcit in the 1978 rural revolution that saw collective farming replaced by the "household responsibility system." Farmers made money form their crops, informal markets were introduced, and prices were allowed to rise above government's approach was amended in 1992, with Deng garnering the political backing and Party Secretary General Jiang Zemin providing the initiative. The revised constitution scrapped the planned economy under public ownership in favor of a "socialist market economy" with "Chinese characterietics." It also provided a rudimentary outline for a "modern enterprise system" by the year 2000, in which government administration would be separated from day-to-day operations and enterprise managers would be given nuts-and-bolts responsibility, Diversified forms of ownership, especially "privately owned, individually owned, and foreign-invested" enterprises, were welcomed. Still, public ownership at all levels of government would remain dominant.

If the socialist market economy was to be the arch supporting the new economic edifece, a reformed state enterprise systen would be its keystone. China adopted internationally based accounting practices.

A new company law laid the groundwork for separating ownership and management of state enterprises. The Chinese authorities reformed the tax code, identified pillar industries at the provincial or city level, and encouraged key enterprises to consolidate into holding companies. These reforms represented real but gradual progress, and much remained to be done. Neither the technological nor financial restructuring of enterprises had been faced, and state enterprises remained mired in inefficiency and low productivity. State enterprises continued to depend on outmoded technologies and obsolete equipment. Their payrolls were too heavy and they were obligated to provide a wide array of social services to their employees. Managers had no incentives to respond to market signals. Most important, markets for labor, capital, and technology remained undeveloped, limiting the enterprises' ability to modernize.

At the Fifteenth Party Congress in September 1997, Jiang announced that reforms of medium-sized and large state enterprises would be accelerated. He proposed two new initiatives: major layoffs (laid-off workers in China still receive minimal salaries) and divestiture of smaller state enterprises through mergers, leasing, selloffs, and, in some cases, bankruptcy. Since then, the government has indicated it is willing to go much further, announcing plans to sell more than lo,ooo of China's 13,ooo medium-sized and large state enterprises. Jiang's message to the congress underscored that the party's leadership would be upheld since only it could guarantee stability while implementing reform. With memories of the 1989 Tiananmen Square protests still fresh, China's leaders want to be sure these reforms are handled with care. If not, they fear they will face a sequel to that tragic event. CHINA'S ALBATROSS CHINA Is home to roughly eight million industrial enterprises, about six million of which are referred to as family or individually owned because they have fewer than eight employees. Nearly so,ooo enterprises are also classified as "other," including private businesses that employ more than eight people and joint ventures between Chinese and foreign businesses. The rest are publicly owned as defined by the constitution but with important differences among them. Only about ii8,ooo are owned by government at the national, provincial, and municipal level and are classified as state-owned enterprises. However, within this group, roughly 13,ooo mediumsized and large state enterprises account for most of the output.

The rest of the 1.9 million public enterprises are owned by townships and villages and are classified as collectively owned. These businesses are unregulated, have little access to the banking system, and rely on local savings and entrepreneurship. Despite these drawbacks, these collectives are outperforming state enterprises and, according to the government, account for 4o percent of total industrial output, while state-owned enterprises account for only 34 percent. Nevertheless, state-owned enterprises dominate major mining and manufacturing sectors: coal, ferrous and nonferrous metals, chemicals, textiles, pharmaceuticals, machine tools, food processing, printing, tobacco, capital goods, fertilizer, motor vehicles, electronics, and defense. Government statistics show that state enterprises still account for 72 percent of industrial assets, 70 percent of industrial employment, and 65 percent of industrial income tax revenues.

But state enterprises are terribly inefficient, tying up over two-thirds of industrial assets while contributing only one-third of output. Many depend on technology that is up to 50 years old. Their plants are obsolete, inefficient, and highly polluting. They survive only because of government cash and credit subsidies. Worker productivity is low. Poor management is a grave problem, with large inventories piling up in many enterprises. According to the government's most recent industrial census, almost half the goo major industrial products surveyed came from factories operating at less than 6o percent of capacity

Collective, individual, family, private, and joint-venture enterprises in townships and villages are often held up as examples for state enterprises to follow. They are largely unregulated and considered by some to be the embodiment of capitalism. But others see their uncontrolled growth as little more than labor exploitation. Workers at these enterprises receive no benefits, low wages, and work in dangerous conditions. In Shenzhen, a short distance from Hong Kong's skyscrapers, some workers are paid as little as 6o cents a day. DOWNSIZING THE MIDDLE KINGDOM A STATE enterprise is more than a workplace. It is a community that tries to provide its workers and their families with the services they need to lead productive and healthy lives. State enterprises employed about 76 million workers at the end of 1993, of which 15 million were officially estimated to be redundant. In addition, about 20 million retired workers are supported by state enterprises. But these behemoths can no longer afford to provide pensions, housing, medical care, child care, education, food, recreation, and transportation for workers and their families. Many state enterprises are attempting to spin off some of their welfare roles as separate service enterprises. But this is only a partial solution because many of these rely on their parent enterprises to provide costly social services such as housing and medical care. The burden of pensions is being shifted to cities and counties, which have adopted unified systems based on premium rates to help spread the costs of retired workers. Most state enterprises pay 18-Zo percent of their payroll into the pension system, but older industries with many retirees pay up to 25 percent. According to government statistics, 78 percent of the work force had joined pension plans at the end of 1996 Progress in other areas has been slower. Only 7 percent of workers and their families were covered by medical insurance in 1996.

State enterprises maintain hospitals, clinics, and schools and build houses for their workers. They employ one-third of the nation's medical staff and 6oo,ooo teachers and administrators. Workers view these benefits as entitlements. But as subsidies to enterprises have been reduced from 6 percent of GDP in 199o to 4 percent in 1994, many enterprises have been forced to meet these expectations without government assistance.

The problem is especially serious for older industries with many aging workers. These enterprises tend to be unprofitable and employees see their benefits dwindling. The lucky ones have an arrangement known as "one family, two systems," which provides housing, health care, and other benefits from other family members who work as civil servants or for profitable enterprises. The unlucky ones are on their own. Economic leadership in a state enterprise is supposed to come from the general manager, while the enterprise's party representative exercises political leadership. Recent reforms have made their respective roles more complementary, with the party secretary ensuring that the enterprise implements new initiatives. But the general manager and party representative's efforts are usually hamstrung by forces beyond their control: the vast government apparatus that controls the management of enterprise assets.

The State Council, China's highest governing body, is the ultimate owner of state enterprises. The National Bureau of State Owned Property, created to implement State Council directives, sits at the top of a hierarchy composed of state asset supervisory committees, state asset management bureaus, and state asset operating companies. Parallel to this structure are 57 large company groups under the central government, which manage state assets directly. According to the World Bank, this multitiered network is burdened with conflicts of interest because lines of authority are unclear and asset management organizations act as both asset owners and enterprise administrators. In addition, the central government retains a virtual veto power over the investments of these enterprises through its national planning function, which determines whether investments are consistent with the current five-year plan. Beijing's reforms have not gone far enough. A GUESSING GAME ALTHOUGH CHINA adopted internationally accepted accounting standards in 1993, accountability is still a foreign concept to most Chinese. The new standards give the same priority to government macroeconomic control as to enterprise management and interested third parties. Consequently, preparation of financial statements is still viewed as only a reporting exercise to a higher authority, so data continues to be manipulated to paint a financial picture that serves the enterprises' interests. Until accounting is seen as a tool for diagnosing financial health, evaluating any enterprise accurately will be impossible. Establishing asset values is difficult because many enterprises have revalued their holdings and the Chinese cling to much longer depreciation periods than is generally acceptable. Assets are often classified on a balance sheet into categories that make identifying individual assets a guessing game.

Establishing the real costs of production is often even more painstaking. Without knowing production costs, it is impossible to determine an enterprise's productivity at each stage of production, let alone the final unit cost of production for each product. Costs are usually determined according to standard formulas rather than market prices, making it difficult to judge whether assets have been used efficiently.

China's new premier, Zhu Rongji, who is credited with reining in inflation, has said that 40 percent of state enterprises are not profitable. The World Bank believes that 50 percent is more realistic, and some say even more are in the red. Regardless of who is right, the problem is intractable. Enterprise profits are overstated and their losses understated because discussions about profitability refer to net profit after deducting enterprise costs, without taking into consideration taxes due the government or interest and principal payments due lenders. Many enterprises are behind in their tax payments, and overdue debt is often rolled over. Between 1978 and 1995, tax revenues declined from 35 percent of GDP to 11 percent. Almost two-thirds of this decline was due to lower tax payments from state enterprises with declining profits. Many enterprises are also caught in a cycle of triangular debt in which they receive at best partial payment from customers and are therefore only able to pay some of their own suppliers. This triangular debt trap was believed to amount to $24 billion in 1994.

The government now has new alarms going off over the rise in corruption. Two factors explain this. Decentralization of economic decision-making from the national to local levels in the late 1970s and early 198os presented local officials with opportunities for graft. Weaknesses in the reform program also left openings for corruption, such as asset removal, which involves stripping state assets through "spontaneous privatization" by managers and employees of state enterprises, often aided and abetted by local government officials. The government estimates the practice has cost China $6 billion a year for the past 15 years. The formation of holding companies, the increasing popularity of mergers, and the rapid growth in joint ventures with foreign firms has led to massive movement of assets, and with them, opportunities for fraud. READY OR NOT STATE ENTERPRISES must modernize by importing new technologies, but they lack the capital, and their high levels of debt hinder their ability to borrow more. They cannot shed excess workers because worker mobility is limited by their ties to enterprises, and the government believes it will take lo to 15 years to establish a national welfare system with portable social benefits. The burden of social expenditures is so heavy for most state enterprises that they have nothing left to invest. For a national welfare system to work, local governments, enterprises, and workers must all contribute. Thus there is no solution in sight for chronically unprofitable enterprises. Beijing has established 36 property-rights transaction centers nationwide to facilitate mergers and acquisitions. It also has promoted the so-called "administrative" merger, in which a profitable enterprise absorbs a money-loser. The government encourages these mergers by granting five-year moratoriums on the interest payments from the unprofitable partner. The government also has been willing to convert triangular debts into equity share capital. In some instances the mergers are completed at the government's insistence. Although a bankruptcy law became effective in 1988, and the government officially supports the liquidation of perennially money-losing enterprises, by 1997 only about one percent of state enterprises had initiated bankruptcy proceedings. Commercial banks, burdened with overdue loans, are reluctant to lend more funds. Joint ventures can help only a small fraction of state enterprises, and equity markets, still in a formative stage, cannot be expected to become a source of financing for the vast majority of state enterprises.

Most recently, the government took a giant step backward by reinstituting subsidies to try to reverse losses to China's "key industries," beginning with its most troubled industry, textiles. There are 4,031 state-owned textile firms, employing four million workers and operating 41.7 million spindles. Since 1993 the industry has suffered deficit after deficit. The situation is so serious that one government official stated that 4o percent of these enterprises are on the brink of collapse.

Instead of letting the market decide which enterprises should survive, the government's strategy is to trim the textiles industry by providing costly subsidies for enterprises that agree to eliminate up to lo million spindles. For every lo,ooo spindles taken out of production, enterprises will receive a $6oo,ooo package of cash and low-interest loans. In addition, the government, as the owner, is swapping debt for equity by buying up bad loans from these enterprises. In 1997, $1.2 billion in debt was converted to equity in 555 state textile enterprises, and twice this amount has been allocated in 1998. About 1.2 million workers will be "diverted" to other jobs in ways not yet spelled out.

It is unrealistic to think that the government will let go of the 1,500 to 2,ooo large state enterprises that dominate heavy industry. The government will try to divest itself of the rest, but many state enterprises cannot pay their debts or meet banks' requirements for new borrowing, have little prospect of generating equity through new equity offerings, and are essentially insolvent. Voluntary divestiture is unlikely to succeed because state enterprises are not attractive investments. Governmentadministered mergers between strong and weak enterprises only hide the problems of the weaker enterprise. The deterioration in state enterprises can only be temporarily reversed if the government reinstates massive budget support, as in the textile industry. Although subsidies will help textile profits in the short term, they will not solve the structural problems of individual enterprises, and another fiscal fix will likely be required soon. The government cannot afford to bail out all these troubled industries. During the 1978 rural reform, loo million rural workers left the farms. The flow continues as expanding cities consume arable land and the disparity between urban and rural incomes widens. These migrants can be seen on the street corners of any major city, waiting for the chance to do any job that urbanites shun. The flow of rural migrants has yet to create a major political problem for the government because they left little behind and had everything to gain by seeking work in urban areas. However, the prospect of additional millions of unemployed state-enterprise workers does concern the government. Along with civil servants, state-enterprise workers are the privileged elite of China's work force. They have everything to lose if they are forced to leave their jobs. They will not go quietly. Beijing's response to the dilemma of maintaining political leadership while promoting economic reform has been to promulgate new legislation and institutional reform without really loosening control over its enterprises. The government is reluctant to go further because it fears that more workers' rights will erode its authority beyond recognition. But the Chinese authorities realize that if they do not deliver the material necessities of life, they will face widespread urban discontent. After 20 years of economic reform, the government is still afraid of facing the consequences of smashing the iron rice bowl. Soon it will have no choice. China must act now to build a national welfare system whose cost is shared by enterprises, workers, and national and local governments. Local governments must waste no time in setting up job retraining programs for workers in danger of losing their jobs. Both Beijing and local governments must create public works projects to provide employment during the difficult transition ahead. The iron rice bowl will be broken. The only question is whether China will be ready.@

[Sidebar]

POLLUTION WITH CHINESE CHARACTERISTICS

[Sidebar]

By law China's state enterprises-which spew vast amounts of dust, gas, liquid effluents, and toxic waste-are required to be environmentally conscious. But most of them depend on coal as an energy source and will for the foreseeable future. According to government statistics, industry accounts for 35 percent of all coal burned in China, 39 percent of all sulfur dioxide emissions, 37 percent of particles emitted into the atmosphere, and 30 percent of China's total greenhouse gas emissions. The efficiency of Chinese industrial boilers is about 6o-65 percent, compared to 80-90 percent in the West. The city of Chongqing, in south-central China, may have the highest sulfur dioxide levels in the world. The problem is not just controlling pollution but putting some distance between polluters and people. Many factories were built in the middle of cities where infrastructure was readily available. An obvious solution would be relocating the worst offenders, such as cement plants and paper and steel mills. However, the government is unlikely to support any policy that would further deplete agricultural land, which is disappearing by 1.5 percent a year. With obsolete production lines and balanced sheets deep in the red, state enterproses have no intrest in expensive pollution control equipment. The environmental protection system currently in place does not adequately punish major polluters. Fines are usually small, and enterprises regard them as a cost of doing business. No matter what consensus the national government has come to on the environment's importance, the decision to clean China's rivers, lakes, and mountains is a local one. At this point China's local polluters are winning the day oger those sympathetic to the environment in Beijing.

[Author note]

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